PROVIDING AN AIR-TO-AIR REFUELLING CAPABILITY

THE PRIVATE FINANCE INITIATIVE ANGLE

Presentation to the 37th DoDCAS
Williamsburg, February 2004

by

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PRIVATE FINANCE INITIATIVE

MoD has involved private finance in a number of defence projects over the past few years:

- aircraft pilot training
- tank transporter
- C-17 lease
- fixed installations
- aerial refuelling

PFI AIMS

A viable Private Finance Initiative solution will:

- Provide a defence capability to meet operational needs
- Involve sufficient risk transfer to ensure value for money compared to the best conventional procurement option
- Be attractive to potential suppliers and financiers

FUTURE STRATEGIC TANKER AIRCRAFT

- The RAF's VC10s have been in service for some 35 years and operate in
  - the Air Transport (AT) role
  - the Air Refuelling (AR) role
- The RAF's TriStar aircraft have been in service for over 20 years and operate in
  - the AT role
  - the AR role
- It is planned to replace both aircraft types with the Future Strategic Tanker Aircraft (FSTA)

FSTA PROJECT BACKGROUND

- FSTA is the largest project in the MOD's extensive Private Finance Initiative (PFI) programme
- FSTA programme estimated Whole Life Cost is approximately £13 billion (in Outturn Prices) with a £2.5 billion capital cost at 2003 economic conditions
- Timetable:
  - Invitation to Negotiate issued December 2000
  - Two consortia submitted formal bids in July 2001
  - Final bids submitted August 2003
  - Replace current fleet around the end of the decade

SERVICE TO BE PROVIDED

- MOD is seeking a service bounded by the maximum number of operational aircraft they can call upon in any one day.
- The service provider will own, manage and maintain the aircraft and provide training facilities and some personnel
- The RAF will continue to retain operational responsibility for all military tasks and will crew the aircraft except when the aircraft are used to earn third-party revenue
- MOD will pay for the AR/AT provision on the basis of availability and usage. Payment will only be made when the service is delivered to a satisfactory standard

SERVICE TO BE PROVIDED

- Likely service provision under the FSTA PFI:
  - Aircraft and spares
  - Special-to-Type Ground Support Equipment
  - Management of Government Furnished Equipment
  - Training of flight crews and other FSTA personnel
  - Engineering and logistic support
  - Sponsored Reserve Air/Ground Crew
  - Fleet management
- The final scope of the service will be based on best value for money

BIDDING CONSORTIA

Two industry consortia are bidding for FSTA:

- AirTanker Ltd

  Cobham, EADS Airbus, Rolls-Royce and Thales

  Solution based on Airbus A330 aircraft

- The Tanker & Transport Service Company

  BAE Systems, Serco, Spectrum Capital and Boeing

  Solution based on Boeing 767 aircraft

POSSIBLE CONTRACT TERMS

- A 27 year contract is expected, to include a
  - specially developed payment mechanism based on availability and usage charges
  - service credit regime to incentivise performance
  - fixed prices for the services to be provided
  - appropriate variation of price condition linked to specific indices
- Opportunities for gainsharing will also be sought

THIRD PARTY INCOME

- Third-party income is a common feature in private finance deals
- The service provider will be able to earn extra revenue by using spare aircraft for approved commercial operations. This will help offset costs to the MoD
- For FSTA the RAF will not need all of the aircraft all of the time so the service provider will be able to earn extra revenue by using spare aircraft for approved commercial operations
- Overriding need for the RAF to have first call on the aircraft in an emergency and oversight of commercial operations for security reasons

THIRD PARTY INCOME

- Companies cannot use military equipment to generate income. So if third-party income involved need to be able to make it civilian quickly
- For FSTA this will require the aircraft to oscillate between the military register and the civil register
- However, requirements of the civil register are different:
  - no explosives or weapons
  - no AR
  - military flying quite different from normal civil airliner operation - fatigue life implications

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INSURANCE

- Governments normally bear the uninsured losses through an indemnity
- PFI providers will normally
  - look to the insurer to pay forthwith if the equipment is lost or damaged
  - for FSTA the Government may cover AR risks if no commercial market insurance cover is available

INSURANCE

- Usually the Government can decide to
  - rotate existing assets to re-generate the capability
  - or give up some military capability
- However, under PFI the asset is owned by somebody else and there will be a contractual obligation on the Government to pay for its replacement or the servicing of the finance, if the loss is covered by a Government indemnity

WHAT HAPPENS IF BULLETS FLY ?

- The RAF continues to be responsible for all Military operations
- For FSTA, the RAF or called-up Reservists will crew the aircraft except when used to earn third-party revenue
- UK law allows for Sponsored Reserves, civilians who have taken on an obligation for military service when called up

LEGAL, ACCOUNTANCY AND OTHER COSTS

- There are costs for both Government and bidders
  - Legal
  - Accountancy
  - Technical
  - Cost analysis
  - Insurance
- PFI bidders also incur significant bid-related costs (including banking and financial market advice)

LEGAL, ACCOUNTANCY AND OTHER COSTS

Some recent UK examples:

- Typically £50M plus for large value defence projects
- For the London Underground PFI a total bill of some £440M was reported for the bidders and for advisors to London Underground

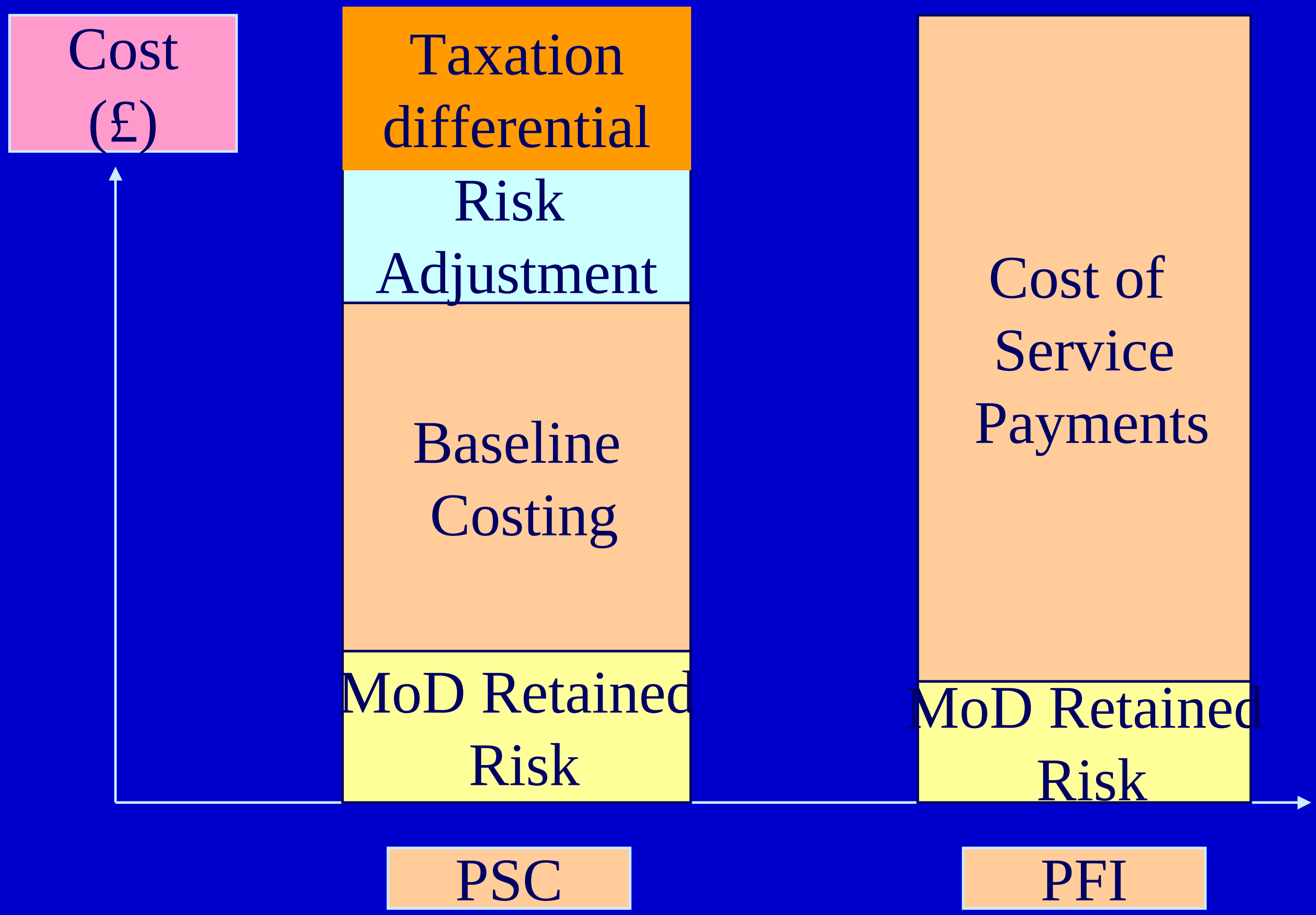
PUBLIC SECTOR COMPARATOR

- A Public Sector Comparator (PSC)is required in order to judge whether the PFI is value for money
- The Public Sector Comparator reflects historic public sector practice but permits “Smart acquisition” e.g PFI the Aircrew and groundcrew Training and Whole Life contractor logistic support
- The PSC does not assume constraints on public capital

TAXATION DIFFERENTIAL

- Essentially, there are fewer taxation receipts from conventional public procurement
- Under PFI tax receipts from
  - interest payments to lenders
  - tax receipts from income stream paid to service providers
- UK Treasury says this taxation effect varies between 2% to 15% of project costs, depending on whether it is an operating lease or finance lease
- The taxation effect is added to the PSC value before comparing with the PFI bid

PSC AND PFI COMPARISON



IMPORTANT RISKS IN PFI CONTRACTS (1)

- Risks may occur over the contract life
  - MoD alters its usage - demand risk
  - Third-party revenue - how much has been assumed by the bidder ?
  - Under performance or non-availability of service - consequences for MoD or the provider
  - Obsolescence/changes in technology - how will the provider cope ?
  - Financial health of the service provider may change

IMPORTANT RISKS IN PFI CONTRACTS (2)

- Further risks to be considered
  - Changes in relevant costs - does this damage the provider's business case ?
  - Compensation on early termination - how much ?
  - Length of contract - drives depreciation charges
  - Residual Value - important element of the provider's business case
  - Will specified performance be achieved ?

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PERFORMANCE MEASURES

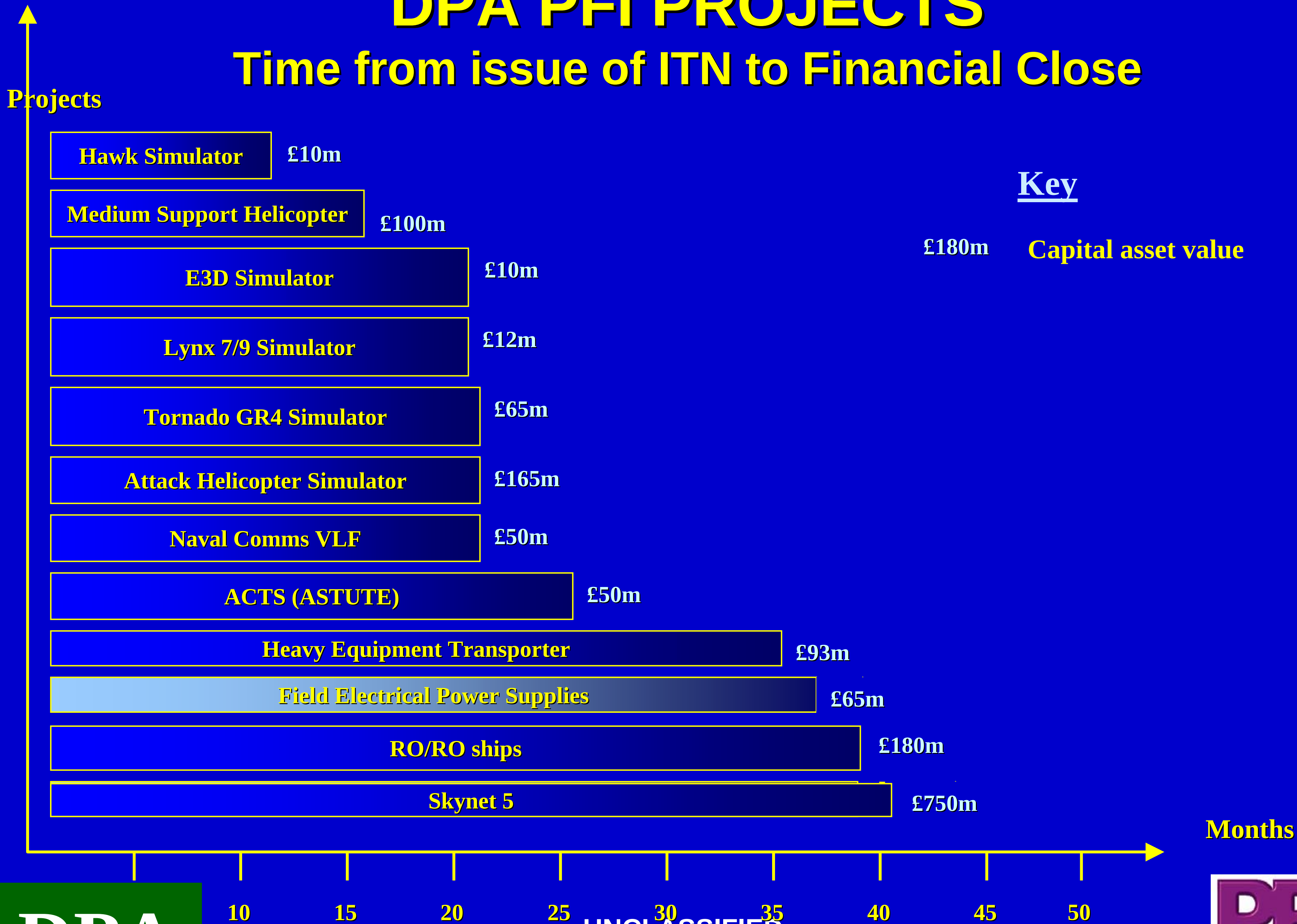
- Define measures of satisfactory performance
  - London Underground even defines what constitutes litter
- Simplify the number of criteria used
  - over 100 formulae in London Underground PFI contract
- Need an exit strategy if service provider fails to live up to his contractual obligations

RESIDUALS

- Define the condition in which the equipment is to be returned to the owner
- The condition affects the residual value
- Residual value affects the leasing charges

DPA PFI PROJECTS

Time from issue of ITN to Financial Close



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LESSONS LEARNED 1

- Long period from Invitation to Negotiate to financial closure
  - creates possibilities for the requirements to change
  - changes may occur in the financial and political climate
- Need contract flexibility to be able to change the service delivery requirements over time
- Consider that the service provider may wish to refinance the deal
  - implications for the Government

LESSONS LEARNED 2

- Contract length affects the service provider's rate of recovery of his outlay and thus his charges to the user
- Charging rates may be linked to defined annual usage - be careful of implications of exceeding that rate
- Make provision for continuation of service if initial provider goes out of business or fails to deliver on his obligations
  - MoD may wish to negotiate rights to take over the contract or place it with with another provider
- What happens if the initial provider is taken over ?

Thank you for listening